David A. Rosenberg
Chief Economist & Strategist
research@gluskinsheff.com
Twitter: @GluskinSheffInc

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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

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SEEKING VALUE IN AN EXPENSIVE WORLD

Well, it's hard to believe that it's been a year since Donald Trump got elected, and at least the good news is that we're still alive. All kidding aside, the question I've been fielding ever since November 8th of last year and to this day is how we are investing around Donald Trump and the answer has not changed one iota which is that we are not investing around Trumponomics at all.

That often raises eyebrows because we all know that the U.S. stock market indices have continued to hit new record highs almost daily, but I would claim that this has had little to do with the President. Actually, if you had owned the basket of Trump stocks the so-called experts told you to own after last year's election, you would have woefully lagged behind.

And of course, it goes without saying that the top performing sector by a country mile, and I am talking about technology, was the area we were all supposed to avoid since Silicon Valley would pay the price for not supporting The Donald. And yet the tech universe is up 35% for the year and has more than doubled the rest of the market. There may be some hope out there that we will see tax reform south of the border, but there is an array of other factors influencing investor sentiment right now. Ongoing supportive global liquidity growth and the vast majority of companies beating their profits and sales estimates are among the reasons.

That said, excessive valuations and the Fed now coupling its rate hikes with balance sheet reduction I think are going to produce some speed bumps for risk appetite in coming months. Between that and the tapering by the ECB and the fact that the Bank of England yesterday joined the Fed on the rate-hiking front, are all very likely going to generate a less calm and more choppy market. Though this actually would be a good thing in terms of opening up some buying opportunities, but taking advantage of these opportunities will require having some dry powder on hand.

In terms of our highest conviction calls, given that we are coming off the 100th month anniversary of this economic cycle, the third longest ever and almost double what is normal, it is safe to say that we are pretty late in the game. The question is just how late, and we did some research looking at an array of market and macro variables, and concluded that we are about 90% through, which means we are somewhere past the 7th inning stretch in baseball parlance but not yet the bottom of the 9th. The high-conviction message here is that we have entered a phase of the cycle to be very mindful of risk, to be bolstering the quality of the portfolio, to be focusing on strong balance sheets, minimal refinancing risk and companies with high earnings visibility and predictability, and with low correlations to U.S. GDP. In other words, the exact opposite of how to be positioned in the early innings of the cycle where it is perfectly appropriate to be extremely pro-cyclical.

So it's either about investing around late-cycle thematics in North America or it is about heading to other geographies that are closer to mid cycle — and that would include Europe, segments of the Emerging Market space where the fundamentals have really improved, and also primarily in Japan. These markets are not only mid cycle and as such have a longer runway for growth, but also trade relatively inexpensively in a world where value is scarce, and for the most part, still have friendly central banks keeping liquidity conditions flush.

I would have to say that if there is a market that has broken out of a 25-year secular downtrend, and where the economic and political tailwinds are significant, it is in Japan. I get told all the time that Japan's population is declining, but we are buying companies, not bodies, and the bottom line is that even with this declining population, earnings momentum is on the rise and profit margins in Japan are on an impressive expansion phase, and not nearly priced in. In fact, Japan is one of the few markets globally that is not trading at premium multiples relative to its history and is an under-owned market both globally and locally.

Turning to Canada, there is some visibility here in the oil price given the high degree of OPEC compliance and the strong likelihood of an extension to the output cut agreement; the drawdown in US inventories; declines in global storage; solid world demand especially from oil-hungry emerging markets; and a geopolitical risk premium coming back into the market because of the uncertainties now over the Iran deal which sits in Congress and these tensions between Iraq and the Kurds. The shape of the curve doesn't lie and the recent move from contango to backwardation is an added sign of how tight the crude market has become. The beauty here is that the Canadian E&P stocks are not priced for where oil is today, testing $55 a barrel for WTI, and over the near term there is more upside potential than downside risk. So they look attractively priced here, once again in a world where inexpensive assets are in short supply. And given the correlations between energy and the Canadian banks, this is good news for this sector as well.

It also seems to me that with the Bank of Canada now on hold and with the Fed likely to raise rates, that there are increased odds of the Canadian dollar faltering further. And if it breaks C$1.30 which is the 200-day moving average, then we are talking about the next test being C$1.35 where there is a ton of technical support.

And let's face it, the economy here is going to need another dose of some currency-related stimulus because of the combination of NAFTA uncertainty, the tightened B20 mortgage regulations (which is sure to bite into the housing market next year), and a clouded fiscal picture in terms of the outlook for taxation (I have no clue as to why the Federal government is adding more complexity to this situation, but it is just another reason for the Bank of Canada to stay on the sidelines).

In any event, the resultant weakening in the loonie is a positive underpinning for many of our sectors, and again, that includes energy where the Western Canada Select price has surged in local currency terms by 25% in just the past two months whereas the TSX energy sector has only rebounded 5%. I should add that there are a host of other Canadian companies in our portfolio that have U.S. dollar revenue streams in areas like real estate, banks, insurers and forest products, that are going to benefit from this renewed period of Canadian dollar weakness.

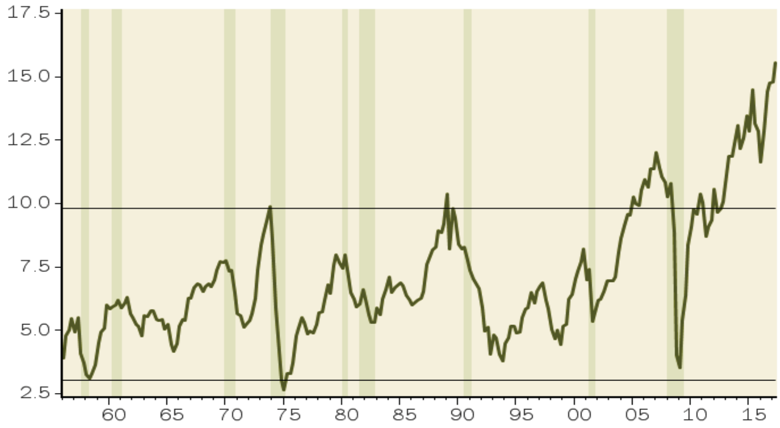
CHART 1: JAPANESE EQUITIES ARE BREAKING OUT

Japan: *Nikkei 225*
(index)

Source: Haver Analytics, Gluskin Sheff

CHART 2: PROFITABILITY HAS SURGED TO ALL-TIME HIGHS UNDER ABE

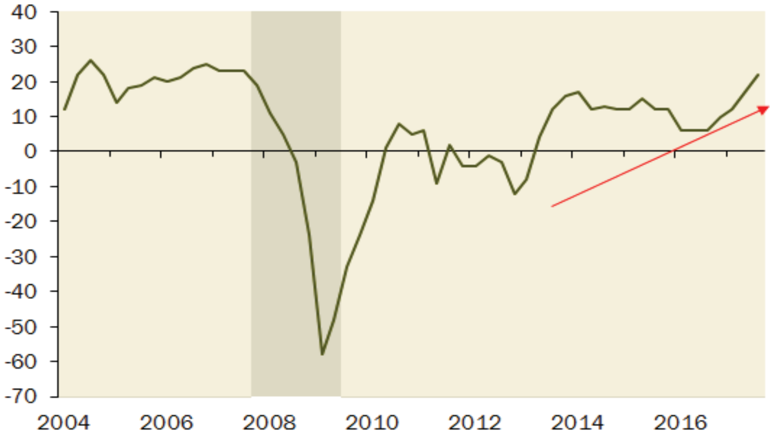
Japan: *Corporate Profits as a Share of GDP*
(percent)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 3: CONFIDENCE IMPROVING FOR BUSINESSES…

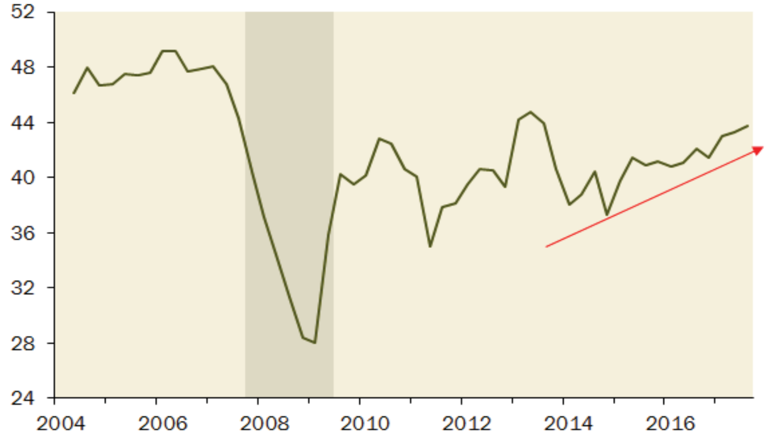
Japan: *Tankan Manufacturing Index*
(index)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 4: …AND FOR HOUSEHOLDS

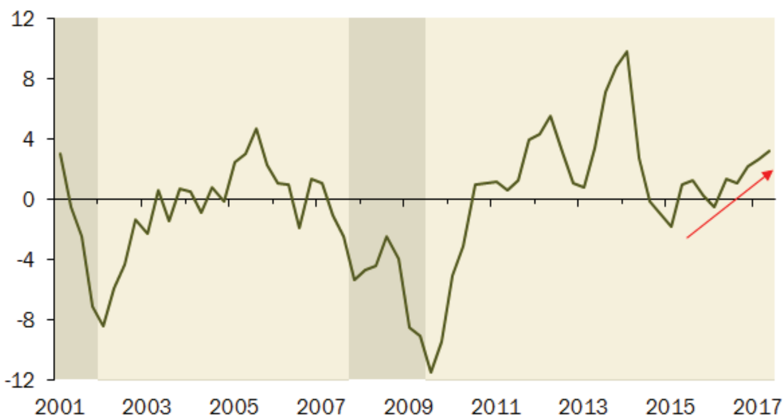
Japan: *Consumer Confidence Index*
(index)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 5: SPENDING BY BUSINESSES STRENGTHENING…

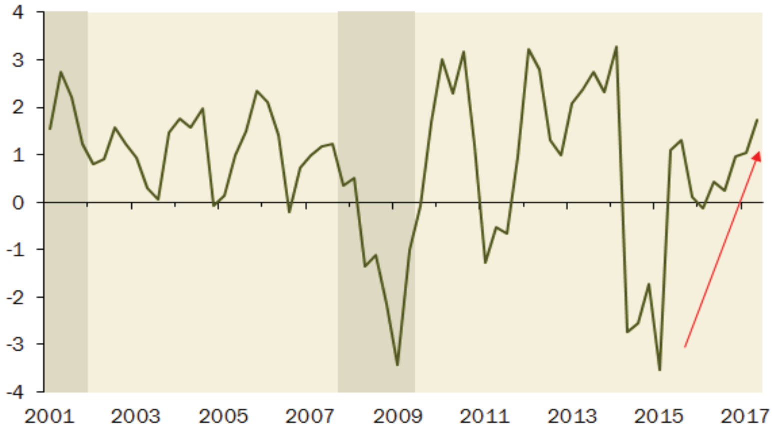
Japan: *Real Fixed Capital Formation*
(year-over-year percent change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 6: ...DITTO FOR HOUSEHOLD SPENDING

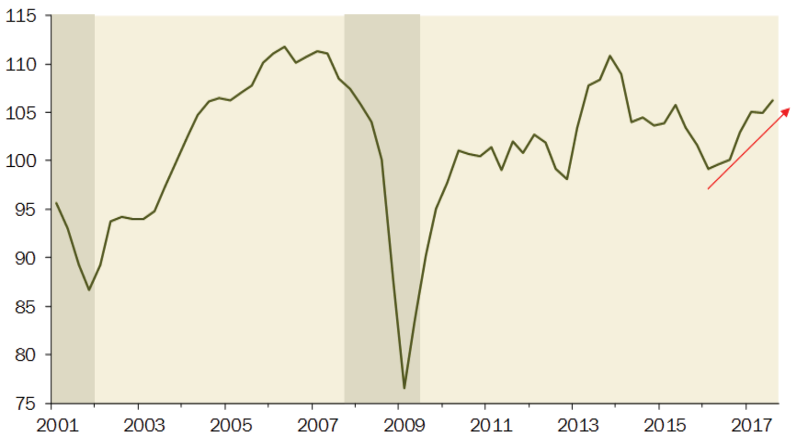
Japan: *Real Consumption Expenditures*
(year-over-year percent change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 7: LEADING INDICATOR SIGNALLING MORE MOMENTUM AHEAD

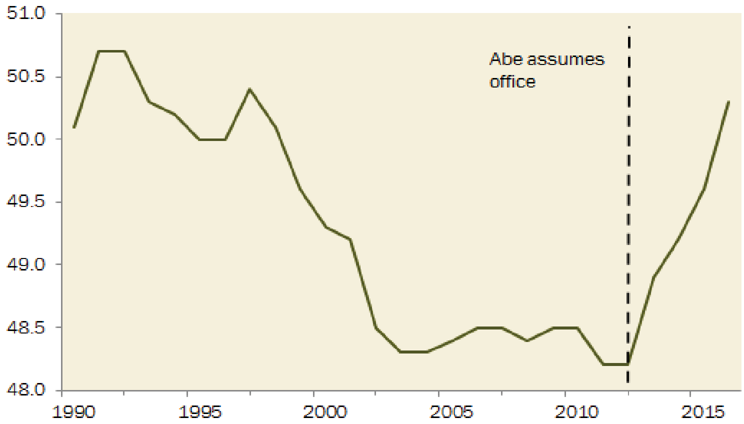
Japan: *Composite of Leading Indicators*
(index)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 8: TOTAL FEMALE LABOUR FORCE PARTICIPATION RATE

Japan
(percent)



Source: International Labour Organization, Gluskin Sheff

Gluskin Sheff

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For further information, please contact: research@gluskinsheff.com

Notes:

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2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.
3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

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